Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

24 February 1984

China: Adopting Fiscal and Monetary Tools

Summary

Beijing's ability to control macroeconomic variables directly has diminished markedly over the past few years as economic decisionmaking authority has devolved to lower levels. As a result, the government has started to experiment with western demand management policies. The banking system has been completely restructured to make monetary policy a viable option, and fiscal tools--including issuance of treasury bonds and alterations in government spending patterns--have been put to use. The experiment will probably continue over the next few years, but in the absence of major price reform, we expect Beijing to remain dissatisfied with the results. [redacted] 25X1

Introduction

During most of the past 30 years China has had little need to use fiscal or monetary policy for demand management. Unlike market economies, where unanticipated shifts in private investment occasionally cause sharp changes in economic activity, the bulk of investment in China has been government controlled. Annual investment decisions were part of the planning process and funds were channeled into sectors that Beijing designated as top priority. With investment largely controlled by the government, the only major source of potential macroeconomic instability was the savings and consumption pattern in the household sector. Here tight wage and price controls were the main tools

---

25X1

This memorandum was produced by [redacted] of the China Division of the Office of East Asian Analysis in response to a Teasury Department request. Questions and comments are welcome and may be addressed to the author [redacted] 25X1

25X1

[redacted]

for curtailing excess demand and dampening inflationary pressures. 25X1

Recently, however, Beijing has given up much of the direct control it once exerted over domestic investment decisions. Economic reforms introduced over the past four years have significantly increased the decisionmaking authority of local firms and individual rural households. Correspondingly, the potential for fluctuations in aggregate demand has greatly increased, while the government's ability to control such fluctuations has declined. Offsetting these negative aspects are the gains in productivity--mostly in rural areas--that can be attributed, in part at least, to the economic reforms. Beijing's present dilemma is how to strengthen control over economic behavior without weakening the reform package and cutting productivity. In pursuit of this goal the government is expanding its available options for conducting effective fiscal and monetary policy. 25X1

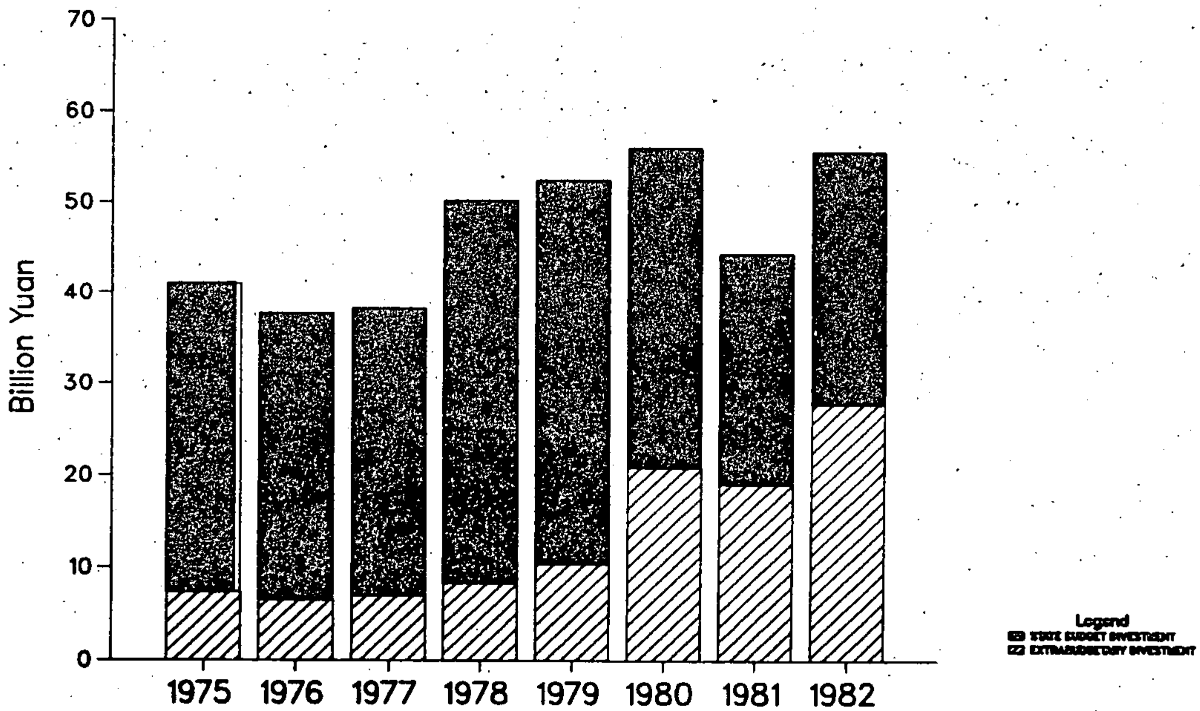
Losing Control

Evidence that Beijing's control over economic activity had weakened is most clearly reflected in investment trends. In 1978, nearly 85 percent of total investment in capital construction was funded through the state budget; by 1982 that share had fallen to less than 50 percent. The bulk of extrabudgetary investment came from local governments and enterprises using retained earnings or funds borrowed from banks. The initial 1982 plan called for a 10-percent decline in total investment in capital construction to 38 billion yuan; instead yearend results showed a 25-percent increase to 55.6 billion yuan. More than 28 billion yuan came through extrabudgetary avenues, a 45-percent increase over 1981. The surge came at a time when Beijing was attempting to hold the line on investment in order to allocate more resources to improve consumer livelihood. 25X1

Burgeoning budget deficits give further evidence of Beijing's problems with control. After registering small surpluses in 1977 and 1978, expenditures exceeded revenues by a record 21 billion yuan in 1979.[1] Although Bejing was able to reduce the size of succeeding deficits, the budget remained 28 billion yuan in the red between 1979 and 1982. Subsidies jumped

[1] The figures given in this paper differ substantially from official Chinese statistics. Beijing includes domestic and foreign borrowing as revenue rather than financing items, in its accounts. On the expenditure side, Chinese statistics exclude payment of subsidies. The figures used in this paper are those modified by the IMF to meet standard Western accounting practices. 25X1

State Share Of Investment In Capital Construction



Approved For Release 2009/06/08 : CIA-RDP04T00367R000201230001-5

an estimated 390 percent between 1978 and 1982 as Beijing boosted agricultural procurement prices (in an effort to improve rural living standards) while holding the line on retail prices (to avoid cutting into urban consumption). By 1982, government subsidies outweighed capital construction as a share of the total budget. Revenue shortfalls exacerbated the deficit as enterprises--exercising their decisionmaking authority--found ways to avoid remitting profits by overstating costs, giving across-the-board wage bonuses, and understating revenues. The drop in net profit remittances from state enterprises was unexpectedly sharp, from over 51 percent of total revenue in 1978, to only 29 percent in 1982. 25X1

The combination of large budget deficits and sharp increases in extrabudgetary investment created strong upward pressure on prices. In addition, the projects financed by the extra-budgetary investment siphonedoff construction materials such as cement, steel, and glass needed to carry out work on major infrastructure projects. And once completed, many of these locally financed projects began competing for raw materials needed by larger more efficient state-run enterprises. 25X1

The mounting economic problems were especially frustrating because of a lack of fiscal and monetary instruments available and Beijing's inexperience in using demand-management tools. On the fiscal side, Beijing traditionally relied on the planning process to determine the level of investment necessary to fully employ economic resources. The commercial and industrial sectors were not allowed to hold cash (transaction were done on an accounting basis only) nor were enterprises allowed to extend credit. Tight control of purse strings enabled Beijing to determine both the direction and volume of investment. As long as the bulk of investment was under central control there was little chance of major unanticipated shocks that might require fiscal response.[2] Nor could Beijing rely on a changing tax policy to serve as a fiscal instrument. Prior to the economic reforms, state enterprises remitted all their profits to the central government. 25X1

Chinese authorities also had none of the traditional monetary tools available to market economies--direct control of money in circulation, manipulation of reserve requirements, or changing interest rates. Monetary policy was first and foremost a reflection of the plan and hence totally passive. Growth of currency in circulation, the most important monetary aggregate,

---

[2] It should be recognized here, however, that Beijing paid a tremendous price in efficiency, because resources moved where they were directed rather than where they were most needed. As often as not political clout--not efficiency--determined the direction of flow. 25X1

rose from a rate of 8.7 percent in 1978 to an unprecedented 29.2 percent in 1980. The reason for the rapid expansion was the deficits in the State Budget, which were financed by the People's Bank of China. Thus, the large volume of investment expenditures, the increase in agricultural prices, and the wage increases pumped substantial currency into the economy. This was not fully offset by withdrawal of currencies through sales of commodities by state commercial departments, inflows of savings deposits, service trade income, agricultural credit repayments, or income from taxation. In 1981 and 1982 the rate of increase of currency in circulation slowed somewhat to around 15 percent and 11 percent respectively; the increase in 1983 was probably about 15 percent. Again, however, the decline was the result of tighter fiscal policies not active monetary policy. 25X1

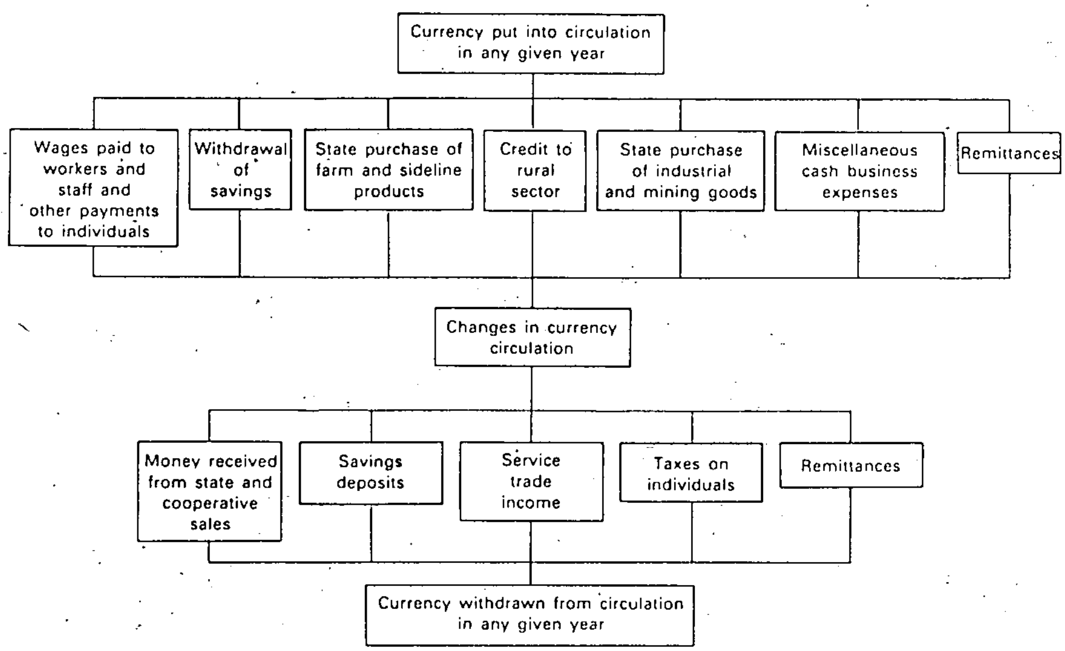
Nor have authorities been able to control domestic credit expansion. During the Cultural Revolution (1965-76), China's banking system was relegated to little more than a cashier/accountant for the Ministry of Finance. Enterprises drew on bank funds as part of their budgetary allocation and, since in most cases they were not required to repay even the principle, interest rates were almost meaningless. In the absence of an active banking sector, credit expansion followed the same trend as currency in circulation, increasing nearly 20 percent in 1979 and 1980, before slowing to 13 percent and 11 percent respectively in 1981 and 1982. Preliminary figures show the 1983 increase to be near 10 percent. About one-third of total loans went to industry, nearly 55 percent for commercial activities, and 8 percent to agriculture. The shares have changed only slightly over the past four years despite Beijing's emphasis on the agriculture sector.

25X1

In fact, the only quasi-monetary instruments used with any effectiveness prior to the early 1980s were wage and price controls. These were directed at the household sector, which used cash in all its transactions and hence was able to change in savings and consumption behavior suddenly. By holding agricultural prices relatively constant from the 1950s to the late 1970s, Beijing was able to prevent surges in the amount of currency circulating in rural sectors and, hence, was able to curb excess demand. Wage controls served the same function in urban sectors. The controls were a major factor in dampening inflationary pressures. 25X1

The absence of an independent monetary policy has not been as problematic for China as it might have been for an economy more fully integrated into the international economic order. China's domestic prices of tradable goods are insulatated from world prices by a system of price equalization. Under this system foreign trade corporations trade in export and import goods with domestic enterprises at prices established by the planners--prices that do not reflect movements in foreign prices and exchange rates. As a result, the exchange rate plays primarily an accounting role and does not affect domestic production or consumption decisions. This system enables Beijing to run sizable trade imbalances without having the normal direct effect on the domestic money supply.

CURRENCY FLOWS



Source: People's Bank of China, "A Financial Survey of the People's Republic of China," *Zhongguo Jinrong*, June 1981, p. 13

25X1

There is an indirect effect through the domestic budget, however, since foreign trade corporations may require substantial subsidies (or generate sizable revenues) as a result of the difference between domestic and foreign prices. 25X1

Experimenting with Fiscal Tools

In an effort to regain at least a portion of the control it once had over economic behavior without disrupting the economic reforms, Beijing began in 1979 to utilize the few fiscal tools at its disposal. Its first priority was to curb mounting inflationary pressures. While using moral suasion to encourage cutbacks in extrabudgetary investment, the government cut sharply into its own spending. Budgetary expenditure on capital construction was flat in 1979, then fell 17 percent in 1980 and 28 percent the following year. Defense expenditures--after rising sharply in 1979 to finance the war with Vietnam--were also cut in 1980 and 1981. Beijing's counsel to reduce extrabudgetary investment was fairly effective in 1979--probably because local enterprises were unsure how much real decisionmaking authority they had--but in 1980 local firms moved into an expansionary phase and extrabudgetary investment doubled to more than 20 billion yuan; for 1982 the figure was 28 billion yuan. 25X1

The attempt to relieve pressure by cutting back government investment proved less than totally effective. In the first place, reductions were offset by other government outlays. Subsidies, for example, rose 21.6 billion yuan between 1979 and 1982, more than offsetting the 21.2 billion yuan decline in government spending for capital construction. Furthermore, by withdrawing resources from much-needed infrastructure projects the government's investment cutbacks may have harmed China's future growth potential. The share of total expenditure allocated to key projects dropped from 42 percent in 1978 to 30 percent in 1982. 25X1

Recognizing the deficiencies in its initial attempts at demand-management Beijing began experimenting with new fiscal tools. In 1981 it issued nearly 5 billion yuan in treasury bonds, which were purchased almost entirely on an involuntary basis. The bonds proved to be remarkably useful fiscal tools, both crowding out funds that would otherwise have gone to extrabudgetary investment and, perhaps more importantly, enabling the government for the first time to operate in the red without simultaneously expanding the domestic money supply. Beijing issued an additional 4 billion yuan in bonds in both 1981 and 1982 and probably a like amount last year. About half the more recent issues have gone to organizations and half to individuals. The latter carry an 8-percent annual interest rate as opposed to only 4 percent for the former. 25X1

In 1983 several additional steps were taken to strengthen fiscal control. A 10-percent tax on extrabudgetary expenditure was introduced to slow unwanted investment and, at the same time, to help finance major infrastructure projects. Another major policy change was the replacement of the system of profit remittances with a system of profit taxation. The new program is designed to put more pressure on losing enterprises by ending automatic subsidies and to encourage other enterprises to earn higher profits on the understanding that these will be shared with the tax authorities rather than confiscated. Other taxes being tried on an experimental basis in a few areas include taxes on fixed assets and circulating capital, and on value-added. Surcharges have been levied against inventories to discourage the production of unwanted merchandise. Revenue collection has also been strengthened with auditing units nationwide cracking down on tax fraud. More than 190,000 auditors were mobilized to spot-check one-third of the nation's enterprises and establishments. Violations amounting to 3.5 billion yuan were discovered, 1.9 billion of which were owed to the state. [redacted] 25X1

Making Monetary Policy an Option

Perhaps the most convincing evidence of China's willingness to experiment with market-oriented, demand-management tools has been its reform of the banking system. Over the past four years Beijing has been setting up a network of commercial and industrial banks to relieve the People's Bank of China (PBOC) of the burden of exercising financial supervision over public enterprises:

-- On 1 January 1984, all commercial banking responsibilities were taken from the PBOC. The Bank is now functions solely as a central bank, formulating and carrying out overall monetary policy.

-- Commercial functions previously carried out by the PBOC have been delegated to the newly formed Industrial and Commercial Bank.

-- The Agricultural Bank--formally reestablished in February 1979 after a 10-year hiatus--now serves as the main channel for state investment and credits to agriculture as well as for collection of revenue in the countryside.

-- The Construction Bank has been placed under joint supervision of the Ministry of Finance and PBOC and is charged with supervising construction investment.

-- A "central bank council"--made up of executives from all the banks--is being formed to discuss important national financial policy questions. The PBOC is expected to play the dominant role in the council. [redacted] 25X1

The major goal of banking reform appears to be to create a banking system capable of rapidly moving surplus funds to locations of greatest economic need. At present, most fixed and working capital requirements continue to be satisfied with budgetary grants channeled through the banking system, but increasingly funds are being loaned on the basis of credit worthiness. As an integral part of banking reforms, greater use is also being made of interest rates to influence economic decisionmaking at the micro level. Interest rates paid on deposits have been raised three times since 1978; the increases have more than kept pace with inflation. New

Annual Interest Rates on Deposits and Loans
(In percent)

Deposits	**Pre-1980 increases**	**Post-1980 increases**	**Post-1982 increases**
Individual			
On sight	2.10	2.88	2.88
Six months	3.60	4.32	4.32
One year	3.96	5.40	5.76
Three years	4.50	6.12	6.84
Five years	5.00	6.84	7.20
Eight years	...	...	9.00
Institutional			
Sight deposit	...	1.8	1.8
One year	...	...	3.6
Two years	...	...	4.32
Three years	...	...	5.04

Loans	**Post-1980 increases**	**Post-1982 increases**
Industrial and commercial		
Working capital	5.04	7.2
Short-and medium-term		
One year or less	5.04	5.04
One to three years	5.04	5.76
Three to five years	5.04	6.48
Additional interest for overdue loans[1]	20.00	20.00
Additional interest on bank loans diverted from their authorized purpose[1]	50.00	50.00
Agricultural bank loans		
Working capital loans	4.30	5.76
Equipment loans		
State farms	4.30	5.04
Communes	2.16	4.30
Rural credit cooperatives		
Household		5.76-10.8
Preferential		2.52

Source: People's Bank of China

1 Surcharges on the rate of interest.

25X1

types of deposits have been created, broadening the range of financial assets individuals can chose from. In 1982, enterprises and organizations were for the first time permitted to hold time deposits, which earn higher interest payments. Perhaps the most important adjustment, however, was the general increase in interest rates on loans implemented in January 1982. The standard rate on circulating capital loans was raised from 5.04 percent per annum to 7.2 percent. Certain other loan interest rates were raised even more. These adjustments have made the structure of interest rates much more rational and hence have made Chinese borrowers and lenders more aware of the true cost of capital. 25X1

The core of institutional reform of the banking system has been significant territorial decentralization of authority and implementation of a kind of "responsibility system" for bank branches. Branches at the provincial level and below may make more loans than provided for in their plans if they can increase deposits above the plan level or economize on planned loans. Bank branches have also been transformed into enterprise-like organizations, with bonuses for employees based on branch profitability. This innovation may be more meaningful now that banking activities are profitable at the margin as a result of the latest adjustments in interest rates. 25X1

Despite the major changes, the monetary authorities continue to have little independent control over economic activity. With its more specialized duties, the PBOC should now be able to monitor credit expansion, deposits, and the rate of growth of currency in circulation more closely. But to correct problems that arise the Bank still depends on its ability to inform government organizations directly responsible for the units where deviations occur. The PBOC continues to exercise little control over the demand for credit. Enterprises are still required to give priority to plan implementation in quantitative terms, and this in turn determines their credit requirements. Under the reforms, however, monetary authorities can directly influence the mobilization of savings from households either by raising interest rates or by improving services to savers. By placing high interest rates on funds going to extrabudgetary investment, they can also influence above-plan borrowing behavior.

25X1

Where to Next?

While it is clear that the Chinese remain concerned about their lack of control over economic behavior, it is equally clear that they remain deeply committed to reform. The pragmatic leadership is convinced that only by taking a more market oriented approach can China reduce the tremendous waste and inefficiency that have characterized its economy over the past 20 years. As a result, we expect to see the experiment with fiscal and monetary policy pick up steam.

25X1

Tax policy is the most obvious area for continued experimentation. The concept of making individual enterprises accountable for their profits and losses is central to the reform movement. Substituting taxes for profit remittances is the only way to harmonize the enterprises' needs for autonomy and the government's need for funds to finance public projects. We expect to see major alterations in the tax rates over the next few years. Where Beijing feels that irrational prices, rather than efficiency, are responsible for a firm's high profits, tax rates will be adjusted upward. Priority industries suffering for any reason will probably be granted tax breaks. The government is unlikely to resort to the cutbacks in its own investment program that were imposed in 1980 and 1981. Beijing's recognition of the importance of the key infrastructure projects to economic development virtually ensures increases in expenditure over the next few years. Large deficits will be avoided by boosting tax revenues through tough enforcement of existing policies first, but also through tax hikes if necessary. Since Beijing considers inflows from treasury bonds and from foreign borrowing as part of revenue rather than debt, it is also likely that these practices will continue. [redacted] 25X1

In many ways China's economic system is well suited for monetary policy. Whereas in Western economies a multitude of constantly changing financial instruments make control of the money supply difficult, Beijing has relatively few instruments for borrowing or lending. Then too, while China's banking system is less homogeneous than it was five years ago, it still retains many of the characteristics of a monobank where the monetary authority is able to exert significant control over the entire banking system. As a result, we believe Beijing will move ahead with monetary reform. The banking system undoubtedly will play a much larger role in financing future investment. Interest rates will probably be raised again this year and preferential rates may be offered for priority sectors of the economy. Little is known yet about the degree of autonomy that may be wielded by the new Industrial and Commercial Bank, but we expect that, over the short term at least, it will continue to function under the close supervision of the PBOC. [redacted] 25X1

While the experiment with monetary and fiscal policy has provided some benefits already, it is unlikely that Beijing will achieve the results it expects. Most of the remaining major economic problems--including the emergence of inefficient industries producing unwanted products, continued waste of energy resources, and the siphoning off of materials needed for priority projects--are directly related to China's irrational pricing system. And macroeconomic demand-management tools are particularly ill-suited for dealing with relative price problems. China's leading economists recognize this weakness and have had a measure of success in pushing the government toward minor price reform; price controls on more than 500 minor consumer items have been relaxed during the past year. But without more major adjustments--which may not begin until after 1985--Beijing could become frustrated by its inability to overcome serious economic difficulties, and could move back toward more direct economic control. [redacted] 25X1

Distribution:

Department of Treasury

1 - Steven Canner, Director, Office of East-West Trade

National Security Council

1 - David Laux, Senior Staff Assistant for China,
Taiwan and Hong Kong

Central Intelligence Agency

1 - DDI
1 - NIO/EA
1 - D/OEA
1 - Ch/Prod/EA
1 - Ch/SDS
1 - Ch/China Division
1 - CH/DOM
1 - CH/DEF
1 - CH/DEV
1 - CH/FOR
5 - CPAS/PDG/IMC/CB
2 - OCR/ISG